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Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

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PANAMA: COPING WITH ECONOMIC DECLINE

Summary

Panama's economic problems have worsened substantially in the wake of the political crisis that erupted last June. A growing budget deficit, unease in the country's important banking sector and sharply lower investment have combined to plunge the economy into a deepening recession that shows no sign of abating. At the same time, stalled progress on economic reforms sought by international lending institutions has left Panama City without access to traditional sources of financing that have fueled past growth. [redacted] 25X1

Concern about domestic political fallout has limited the government's willingness to exert greater control over spending or to impose harsh austerity measures. Instead, the regime is relying on fiscal sleight of hand and internal financial resources--including heavy borrowing from government agencies and banks--to stem its growing deficit. Panama also is attempting to expand commercial ties and to solicit

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financial support from foreign governments, including Libya and Cuba. [redacted] 25X1

Although the regime may be successful in avoiding a debilitating liquidity crisis or bankruptcy in the coming months, its resort to stopgap measures and its inattention to serious structural budget and trade flaws will further undermine the country's economic prospects. As a result, Panama is likely to experience negative economic growth, sharply higher unemployment, and declining living standards over the next year. Such developments would pose potentially serious problems for the regime as it attempts to maintain political stability and to generate popular support for the ruling coalition in national elections scheduled for May 1989. General disaffection with the economy, however, probably would be insufficient by itself to precipitate dramatic political change in Panama. While official US economic and security interests are unlikely to be affected directly by Panama's economic slide, private business concerns would face greater difficulties operating in Panama. [redacted] 25X1

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The outbreak of political turmoil in Panama last June abruptly ended two and a half years of solid economic growth. The economy had grown by roughly 3 percent each year in 1985 and 1986, primarily because of modest expansion in Panama's service sector--which accounts for about three fourths of GDP--and large resource inflows from multilateral and commercial lenders. On the strength of significant economic reforms, Panama City had secured more than $100 million from the IMF and World Bank and more than $350 million in debt relief from commercial lenders in 1986. [redacted] 25X1

Recession Takes Hold

The political crisis, however, has had a dramatic impact on economic growth, the government's financial situation, and the country's important banking sector. Embassy [redacted] 25X1 reporting indicates that the Panamanian economy has slumped sharply since the political crisis erupted. Our Embassy estimates that there was no aggregate real economic growth last year and that unemployment probably reached 15 percent, a sharp increase over the 10 percent rate in 1986. [redacted] 25X1

A wave of capital flight that rocked Panama's banking system between June and September of last year was the key precipitate of the economic slowdown. [redacted] Although [redacted] the banking system 25X1 has regained a degree of stability since October, private

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investment and employment in industries dependent on bank credit remains depressed because of reduced liquidity and restrictive lending practices. Government statistics indicate, for example, that the construction industry declined by more than 6 percent in 1987. [redacted] 25X1

A number of other economic indicators signal the depth of Panama's recession. Tight credit and reduced public confidence have contributed to lower consumer spending since June. Retail trade fell by more than 2 percent in 1987, according to government estimates, while restaurant and hotel activity declined by 3 percent. US Embassy reporting indicates that tourism has declined by roughly 30 percent since the crisis began. [redacted] 25X1

Scarce Financial Resources

The government has been unable to cushion the country's economic slide by increasing its own spending because of tight financial resources and problems raising more funds. The Embassy estimates that Panama City's budget deficit for 1987 exceeded $250 million, and the regime has failed on several occasions to meet its financial obligations on time:

-- Panama City was unable to pay off [redacted] 25X1 government notes that commercial banks unexpectedly redeemed in November.

-- The regime delayed payment of Christmas bonuses to public employees for one week in mid-December, according to Embassy reporting.

-- The government has delayed payments to commercial suppliers and has been slow to meet some obligations to commercial and multilateral creditors, according to Embassy [redacted] 25X1

Panama City has been unable to ease its financial problems by garnering new capital funding from multilateral or private lenders. Last year, the regime received only about 10 percent of the international investment financing it had anticipated, according to Embassy reporting. Nearly $140 million in capital inflows from the World Bank and the IMF were lost when the government shelved its efforts to overhaul the troubled social security system. Panama City reportedly is asking for $100 million in new funding from commercial lenders, but bankers remain unwilling to extend any additional loans in the absence of an agreement with multilateral institutions. [redacted] 25X1

Regime efforts to solicit financial support and expand commercial ties with foreign governments have met with only limited success. New agreements for the rotation of Soviet fishing crews initially will net Panama $1.5 million over the next three years, and the use of warehouse and repair facilities

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by Soviet vessels will bring in additional funds. [redacted] 25X1
that pleas to 25X1
five West European governments for nearly $60 million in loans last October have brought no firm commitments. [redacted] 25X1

The government's financial position also has been hurt by a decline in government revenues from import and sales taxes, as well as lower earnings from lottery and casino operations. [redacted] the government's income has fallen 25X1 significantly since last June--by as much as 30 percent, according to one estimate. [redacted] 25X1

So far Panama City has relied on internal financial resources and fiscal sleight of hand to maintain its precarious position. Embassy [redacted] reporting indicates, for example, 25X1 that the National Bank of Panama--the country's equivalent of a central bank--has been using reserve funds to sustain government operations. The regime also reportedly is continuing its traditional practice of draining revenues from profitable state enterprises like the electric utility company. Panamanian officials have told the US Embassy that the Defense Forces have hidden financial resources that may be used to bolster the government's budget. [redacted] 25X1

Limited Efforts to Cut Spending

The political clout of Panama's 150,000 public employees has sidetracked government attempts to implement austerity measures. The legislature rejected the administration's initial budget submission in December because it mandated steep cuts in public employment--which accounts for nearly 40 percent of central government expenditures--and failed to provide funding for public works projects. The administration has yet to put forward a new budget proposal [redacted] 25X1
Anxious to head off spending cuts, a government employee association staged a two-day work stoppage in early December to signal its opposition to salary or workforce reductions. [redacted] 25X1

Unable to push through an austerity package, the government instead has resorted to quick fixes in a bid to close the gap between revenues and outlays. The US Embassy reports that Panama City has slashed capital spending since June--a measure traditionally used by the government to close budget deficits--and has delayed payments to suppliers of commercial goods and services. [redacted] the regime also is 25X1 attempting to control travel and transportation expenses, salary increases, and new hiring. [redacted] 25X1
[redacted] that government auditors hand-delivered salary checks to 25X1

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employees in some offices last October in an effort to eliminate padding the payroll with non-existent workers. 25X1

The regime has expanded its breathing room by avoiding heavy debt payments. Panama City unilaterally suspended all payments to official creditors in June--before the unrest began--in an unsuccessful effort to secure a formal rescheduling of $250-300 million in obligations, according to the US Embassy. Furthermore, Panama's commercial lenders in August agreed to reschedule more than $400 million in principal payments until March 1988. 25X1

Outlook

In our judgment, Panama's economy is unlikely to rebound during the 15 months leading up to national elections scheduled for May 1989:

-- Real economic growth is likely to be sharply negative this year as the government's credit demands and banks' restrictive lending to local businesses limit investment.

-- Unemployment may increase dramatically as the current recession deepens and local businesses reduce spending and inventories.

-- The regime is unlikely to obtain new external funding from multilateral institutions and commercial banks unless it enacts economic reforms. 25X1

Nonetheless, the government hopes to avoid a debilitating economic crisis through a careful husbanding of resources, some spending cuts, and financial aid from non-traditional sources. Although tax revenues are likely to slip further this year, we believe Panama City still has some room to juggle its resources and maintain a manageable cash flow. Barring a resurgence of political turmoil, domestic banking conditions are likely to remain stable, giving the government continued access to some internal funding to manage its budget crisis. Moreover, we believe the regime and the military still have hidden financial reserves that can be tapped to fill any severe funding gaps. 25X1

Popular pressures and intense political lobbying probably will force Panama City to ease its austerity plans, but we believe that senior officials are sufficiently concerned about the government's financial straits to press forward with at least some spending cuts. Judicious use of attrition, early retirement, and limited layoffs would help to trim a bloated public sector workforce and yield some payroll savings. Similarly, by sharply limiting investment spending and selectively cutting nonessential public services--actions that carry little immediate political cost--the government probably can hold major capital expenditures to a minimum. 25X1

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Continued cooperation between Panama City and its commercial creditors will be a key determinant of the regime's ability to survive financially, and we believe both parties are eager to avoid confrontation. The government probably will try to meet at least some of its interest obligations while insisting that large principal payments be deferred. For their part, commercial bankers likely will agree to reschedule principal payments, as they have with other Latin debtors. Although unwilling to provide any new funding, bankers have indicated that Panama's interest burden could be adjusted by a variety of mechanisms, including the retiming of payments or a reduction in interest rates In the absence of an 25X1 accord with creditors, however, Panama probably will choose to declare a unilateral debt moratorium--a politically sensitive step that would torpedo confidence in the regime and limit recourse to future financing--rather than fail to meet critical domestic expenses. 25X1

Despite its lack of progress to date, Panama City most likely will intensify its attempts to attract assistance from foreign governments. Even limited success could give the regime additional breathing room. Although the track record of potential benefactors such as Cuba and Libya in providing financial assistance is poor, Panama's strategic position astride the Canal and its current anti-US posture could tempt these or other donors to provide a limited financial safety net. 25X1

Panama's economic decline poses potentially serious problems for the regime as it attempts to maintain political control and to generate domestic support for the ruling coalition in national elections scheduled for May 1989. Although the government may be successful in avoiding a debilitating liquidity crisis or bankruptcy in the coming months, its resort to stopgap measures and its inattention to serious structural budget and trade flaws will further undermine economic prospects and jeopardize remaining popular support. Nonetheless, general disaffection with the economy--unless accompanied by massive street protests led by a well organized and credible opposition--probably will be insufficient in and of itself to precipitate dramatic political change in Panama. 25X1

Implications for the United States

In our judgment, official US economic and security interests--including the efficient operation of the Panama Canal and the US military's Southern Command--are unlikely to be affected directly by the deteriorating economy. To the extent that the regime is successful in blaming the United States for its economic troubles, however, some economic-related violence or labor disorder could be directed against official US personnel and facilities. 25X1

The deteriorating economy will present growing challenges and problems for private US business interests in Panama. The US Embassy estimates that actual US direct foreign investment in Panama totals some $1.5 billion, concentrated in the petroleum sector, agriculture, and banking. Prolonged street violence or labor unrest could make operating conditions increasingly difficult for the 50 major US companies and banks which do business in Panama. In particular, unstable banking conditions or precipitous actions by the regime could jeopardize US-owned assets in the banking system, which is dominated by nine US institutions. Similarly, Panama City's growing financial problems--and the potential for an official moratorium on debt payments--could put the loan portfolios of US creditors holding Panamanian debt at greater risk. 25X1

Over the longer term, US economic and security interests in Panama may be threatened by the regime's efforts to expand economic and commercial relations with non-Western governments. We believe it is unlikely that limited economic ties to Libya and the Soviet Union will translate into substantial political or diplomatic gains for these countries in Panama before 1989. The regime's continuing need for financial support, however, eventually could make Panama City willing to upgrade its ties to these governments, a development that could undermine US strategic goals and bilateral ties with Panama. 25X1

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